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Virginia Supreme Court Holds That Sale of Closely-Held Business is Subject to the State Securities Act's Civil Liability Provisions

The Virginia Supreme Court recently held in *Andrews v. Browne*, 2008 Va. LEXIS 74 (Va. June 6, 2008), that the sale of stock of a closely-held corporation was subject to the civil liability provisions of the Virginia Securities Act. The unanimous opinion reversed a lower court's determination that the sale of a business fell outside the scope of Virginia's securities laws. The state supreme court's holding is significant because it provides purchasers with an important additional remedy and may significantly increase the risk of liability for sellers who make unintentional misrepresentations or unknowingly provide incomplete information.

Section 13.1-522 of the Virginia Securities Act imposes civil liability for any person who, among other things, "sells a security by means of an untrue statement of a material fact or any omission to state a material fact necessary in order to make the statement made, in the light of the circumstances… not misleading." The seller of the security has the burden of proof to show that "he did not know, *and in the exercise of reasonable care could not have known*, of such untruth or omission." Accordingly, the Virginia Securities Act does not require a showing of fraudulent intent as a precondition to liability.

State securities laws, also known as "blue sky laws," were enacted to protect investors who purchase securities that are not registered under federal securities laws. Several states have adopted the "sale of business" doctrine, however, and concluded that the sale of a closely-held company should not be covered by blue sky laws. Those courts reasoned that the stock being transferred to the purchaser was passed incidentally as indicia of ownership of the business assets and was not a "security" subject to state regulation.

In *Andrews*, the Virginia Supreme Court rejected the "sale of business" doctrine. Instead, the court followed federal law and adopted the "economic reality test," which looks for common characteristics of stock to determine whether the shares being sold were "securities" as defined in the Virginia Securities Act. These characteristics include the right to receive dividends, the right to vote, and the ability to appreciate in value. The court concluded that, "[w]hen the instrument purchased bears the label 'stock' and possesses the characteristics of traditional stock, the purchaser is justified in assuming that the Virginia Securities Act applies…. regardless of whether control of a business is changing hands."

The applicability of the Virginia Securities Act is significant because it increases the liability risks for sellers of closely held businesses. In particular, purchasers can try to avoid the stricter requirements associated with alleging common law fraud. The Fourth Circuit Court of Appeals has held, for example, that the Virginia Securities Act does not require a plaintiff to prove reliance or causation. In addition, because the seller has the burden to show that it acted with reasonable care, these claims may be difficult to dismiss at early procedural stages of litigation. Moreover, the Virginia Securities Act provides that a purchaser can recover its attorneys fees if successful in the litigation.

The ramifications of *Andrews* and whether it will give rise to more state-level securities litigation claims remains to be seen. If it does, this may be an area deserving of legislative scrutiny. In any event, sellers and their advisors must closely consider the decision's implications in planning a sale of a closely-held company. One potential issue is the enforceability of contractual indemnification provisions, because the Virginia Securities Act provides that any waiver of its provisions by a purchaser of securities is void. Some sellers may try to avoid application of the Act by structuring the transaction as a sale of assets, but that option frequently will be impractical for tax and other reasons. Thus, at a minimum, sellers must closely review their representations and warranties being made in the underlying purchase agreement. They must also manage the due diligence process carefully, particularly where there is a significant amount of information being shared with prospective purchasers by the sellers' employees or advisors, in order to ensure that purchasers are being provided complete and accurate information.

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